

Message Text

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ACTION EB-08

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FM AMEMBASSY LISBON
TO SECSTATE WASHDC 3515

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 8292

DEPT PASS TREASURY FOR SYVRUD

E.O. 11652: GDS
TAGS: EFIN, ECON, PO
SUBJECT: FINANCIAL ASSISTANCE FOR PORTUGAL

REF: LISBON 8236

1. DEPUTY ASSISTANT SECRETARY HORMATS AND ECON COUNSELOR FERRER REVIEWED PORTUGUESE ECONOMIC DEVELOPMENTS WITH SILVA LOPES AND VITOR CONSTANCIO, RESPECTIVELY GOVERNOR AND VICE-GOVERNOR OF BANK OF PORTUGAL, MORNING OF OCTOBER 27. PORTUGUESE OFFICIALS EXPRESSED REGRET THAT ECONOMY, AND PARTICULARLY BALANCE OF PAYMENTS, HAD NOT DEVELOPED AS THEY HAD FORESEEN. MAJOR REASONS FOR THE UNEXPECTED DEVELOPMENTS WERE INCREASED MONEY VELOCITY AND HIGHER INFLATIONARY EXPECTATIONS. BALANCE OF PAYMENTS DEFICIT THIS YEAR MAY REACH \$1.2 - 1.3 BILLION. IN FACT, DEFICIT COULD GO AS HIGH AS \$1.4 BILLION. (EMBASSY BELIEVES THIS LATTER FIGURE IS PROBABLY TOO PESSIMISTIC.)

2. CONVERSATION FOCUSSED ON GOP/IMF DISCUSSIONS. FOLLOWING SUMMARIZES CURRENT VIEWS ON MAJOR ISSUES:

A. BALANCE OF PAYMENTS: GOP AND IMF HAVE AGREED ON
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A 1978 CURRENT ACCOUNT BALANCE OF PAYMENTS DEFICIT TARGET OF \$800 MILLION. TARGET ASSUMES CAPITAL ACCOUNT WILL BE IN SURPLUS BY APPROXIMATELY \$200 MILLION, LEAVING A BALANCE OF \$600 MILLION TO BE FINANCED. BOTH GOP AND IMF APPARENTLY FEEL THAT THIS LEVEL OF DEFICIT FINANCING IS MANAGEABLE.

B. BUDGET: GOP IS PROPOSING 1978 CURRENT ACCOUNT

BUDGET OF ESC. 220 BILLION, INCLUDING AUTONOMOUS AND DECENTRALIZED AGENCY OUTLAYS. THIS LEVEL OF EXPENDITURES REPRESENTS AN ESTIMATED NOMINAL INCREASE OF 16 PERCENT. REVENUES ARE EXPECTED TO GROW NOMINALLY BY 33 PERCENT. GOP HAS OBTAINED IMF CONCURRENCE OF THIS EXPENDITURE LEVEL FOR THE CURRENT ACCOUNT, BUT DIFFERENCES OF OPINION STILL EXIST REGARDING CAPITAL OUTLAYS. GOP HAS PROPOSED EXPANDING CAPITAL EXPENDITURES BY ESC. \$14 BILLION. IMF MISSION WISHES TO REDUCE THIS INCREASE BY APPROXIMATELY ESC. 4 BILLION. ALTHOUGH PROJECTIONS OF 1978 RATE OF INFLATION ARE DIFFICULT, AGREEMENT EXISTS THAT IT WILL APPROXIMATE 25 PERCENT, GIVE OR TAKE SEVERAL POINTS. ON THAT BASIS, CURRENT ACCOUNT EXPENDITURES IN REAL TERMS WOULD DECLINE BY APPROXIMATELY 8-10 PERCENT.

C. CREDIT CEILINGS: A MAJOR DIFFERENCE OF OPINION EXISTS OVER CREDIT CEILINGS. GOP ESTIMATES THAT CREDIT EXPANSION THIS YEAR WILL REACH ESC. 155 BILLION. IMF INITIALLY REQUESTED THAT THE NOMINAL INCREASE IN 1978 BE HELD TO ESC. 99 BILLION. GOP COUNTERED BY SUGGESTING A CEILING OF ESC. 130 BILLION. IMF MISSION SUBSEQUENTLY AGREED TO A LEVEL OF ESC. 104 BILLION, BUT GOP MAINTAINS THAT THIS LEVEL IS STILL FAR TOO LOW, PARTICULARLY GIVEN EXPECTED RATE OF INFLATION NEXT YEAR. GOP CONCEDES THAT CREDIT RESTRAINT IS ESSENTIAL TO REDUCE INFLATIONARY EXPECTATIONS AND THE BALANCE OF PAYMENTS

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DEFICIT, BUT FEARS THAT EXCESSIVE CONSTRAINT WOULD LEAD TO MASSIVE UNEMPLOYMENT. QUESTION IS FURTHER COMPLICATED BY UNPREDICTABILITY OF MONEY VELOCITY TRENDS. FURTHER DISCUSSION ON THIS ISSUE WILL CONTINUE THIS WEEK AND NEXT.

D. INTEREST RATES: ALTHOUGH IMF HAS NOT RAISED SPECIFIC CRITICISM OF INTEREST RATES, IT HAS CLEARLY SIGNALLED ITS UNHAPPINESS WITH CURRENT LEVEL AND STRUCTURE OF INTEREST RATES. IMF APPARENTLY WISHES TO SEE BOTH AN INCREASE IN THE RATES AS WELL AS A REDUCTION IN THE RANGE OF RATES. BANK OF PORTUGAL SERIOUSLY CONCERNED THAT SUBSTANTIAL INCREASE IN RATES WOULD FORCE NUMEROUS COMPANIES INTO BANKRUPTCY AND WOULD FURTHER DAMPEN INVESTMENT INITIATIVES.

E. IMPORT RESTRICTIONS: IMF PRESSING GOP FOR ELIMINATION OR AT LEAST SUBSTANTIAL REDUCTION IN CURRENT IMPORT RESTRICTIONS. GOP HAS SIGNALLED ITS WILLINGNESS TO ELIMINATE THE PRIOR DEPOSIT REQUIREMENT AND IS DISPOSED TO REDUCE THE LEVEL OF IMPORT SURCHARGES. IN ADDITION, IT WOULD BE

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C O N F I D E N T I A L SECTION 2 OF 2 LISBON 8292

DEPT PASS TREASURY FOR SYVRUD

WILLING TO ELIMINATE SOME OF THE ITEMS CURRENTLY SUBJECT
TO THE SURCHARGES. IT DOES NOT BELIEVE, HOWEVER, THAT
IT CAN ELIMINATE ALL SURCHARGES (AND PRESUMABLY QUOTAS)
WITHOUT SERIOUSLY DAMAGING THE BALANCE OF PAYMENTS.
PORTUGUESE OFFICIALS COMPLAINED BITTERLY ABOUT RECENT
PROPOSAL RECEIVED FROM EUROPEAN COMMUNITY REQUESTING THAT
PORTUGAL LIMIT ITS TEXTILE AND CLOTHING EXPORTS TO
EC MEMBER STATES TO 1976 LEVELS.

F. EXCHANGE RATES: NO SERIOUS DISCUSSION HAS
APPARENTLY YET BEEN HELD ON PORTUGAL'S EXCHANGE RATE
LEVEL. HOWEVER, IMF HAS STATED THAT THE CURRENT SLIDING
PEG PROVIDING FOR A 1 PERCENT DEVALUATION PER MONTH
IS TOO RIGID. IT DOES NOT PROVIDE GOP SUFFICIENT FLEXI-
BILITY TO RESPOND TO UNEXPECTED SHIFTS IN SUCH FACTORS
AS EXCHANGE FLOWS AND INFLATION TRENDS. BANK OF
PORTUGAL OFFICIALS RADPFBQZED #ZYQPYC) DEOHCOR THIS
VIEWPOINT, THEREBY SIGNALLING THEIR PROBABLE WILLINGNESS
TO ADJUST THE PRESENT EXCHANGE RATE POLICY. THEY
INSISTED, NEVERTHELESS, THAT A SHARP DEVALUATION OF THE
ESCUDO WOULD NOT HAVE MAJOR BALANCE OF PAYMENTS BENEFITS.
THE CONFIDENCE FACTOR IS CURRENTLY SO NEGATIVE AND THE
DOMESTIC PRODUCTION SYSTEM SO UNRESPONSIVE, THEY CLAIM,
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THAT A MAJOR DEVALUATION GENERALLY TRANSLATES INTO HIGHER

DOMESTIC PRICES WITHOUT A COMPENSATORY CHANGE IN INVESTMENT FLOWS OR EXPORTS. ONLY AN EXTREMELY LARGE DEVALUATION WOULD AFFECT POSITIVELY THE BALANCE OF PAYMENTS, BUT THE NEGATIVE DOMESTIC IMPACT WOULD PROBABLY RUPTURE THE EXISTING POLITICAL STRUCTURE. THEY ADMITTED, HOWEVER, THAT EXCHANGE RATE DEVALUATION MUST AT LEAST MAINTAIN THE PROFITABILITY OF THE EXPORT SECTOR.

2. POLITICAL CONSTRAINT: CENTRAL BANK OFFICIALS EXPRESSED CONSIDERABLE CONCERN ABOUT THE PORTUGUESE POLITICAL SYSTEM'S ABILITY TO ABSORB THE SHOCK IMPLIED BY IMF RECOMMENDATIONS FOR CREDIT CEILINGS AND INTEREST RATE STRUCTURES. THEY ADMITTED THAT PORTUGUESE PUBLIC HAS ADJUSTED TO THE NEED FOR GREATER CONSUMPTION RESTRAINT. IMF POLICIES, HOWEVER, THEY STATED, WOULD IMPLY AN INCREASE IN UNEMPLOYMENT THAT THE PUBLIC COULD HARDLY BE EXPECTED TO ACCEPT. THEY VOLUNTEERED THAT THE NUMBER OF PEOPLE WHO ARE NOSTALGIC FOR THE PRE-REVOLUTIONARY REGIME IS INCREASING AND THE ARMED FORCES RESIST FURTHER REDUCTIONS IN MILITARY EXPENDITURES. EVIDENTLY THEY BELIEVE THAT SUBSTANTIAL FURTHER CUTS IN EXPENDITURES WOULD SERIOUSLY ENCOURAGE THE ARMED FORCES TO ASSUME A MUCH LARGER POLITICAL ROLE.

3. U.S. \$300 MILLION LOAN: SILVA LOPES REPEATED THAT THE ONLY MAJOR PROBLEM HE FORESEES IN THE DRAFT AGREEMENT FOR THE USG \$300 MILLION LOAN IS THE CURRENT PROVISION MAKING THE GOVERNMENT OF PORTUGAL THE BORROWER. HE PROMISED, HOWEVER, TO PROVIDE AN INFORMAL PAPER DISCUSSING GOP REACTIONS TO THE DRAFT LOAN AGREEMENT. BOTH PORTUGUESE OFFICIALS STRESSED THE IMPORTANCE OF DRAWING DOWN PART OF THE LOAN AS SOON AS POSSIBLE
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BECAUSE NOVEMBER WILL BE A VERY DIFFICULT MONTH. FOREIGN EXCHANGE LOSSES FOR SEPTEMBER AND OCTOBER ARE ESTIMATED AT \$150 MILLION, BUT THIS LEVEL WILL INCREASE SHARPLY IN NOVEMBER WHEN A NUMBER OF SHORT-TERM LOANS WILL MATURE. BANK OF PORTUGAL HAS ENTERED THE COMMODITY MARKET ON A LARGER SCALE THAN PREVIOUSLY PLANNED. LAST MONTH IT SOLD AN EQUIVALENT OF \$50 MILLION AND PLANS TO CONTINUE SALES AT MORE OR LESS THIS LEVEL AS LONG AS THE MARKET PERMITS. DESPITE THESE SALES, BANK OF PORTUGAL CLEARLY WILL BE IN DIFFICULT POSITION UNLESS IT CAN DRAW AGAINST USG LOAN, PARTICULARLY GIVEN THAT ITS CURRENT LIQUID ASSETS ARE ONLY \$120 MILLION. PORTUGUESE OFFICIALS FEEL THAT IMF CAN ALREADY ISSUE LETTER STATING THAT NEGOTIATIONS ARE PROCEEDING IN GOOD FAITH. IN FACT, PORTUGUESE OFFICIALS FEEL THAT A TENTATIVE AGREEMENT WITH IMF MISSION MAY BE REACHED BEFORE THE LETTER DEPARTS LISBON NOVEMBER 4.

4. COMMENT: DISCUSSION INDICATED THAT GOP OFFICIALS HAVE THOROUGHLY DISCUSSED THEIR VARIOUS ECONOMIC OPTIONS. WHILE SOME DISAGREEMENT STILL EXISTS ON INDIVIDUAL POINTS, THEY UNDOUBTEDLY UNDERSTAND CLEARLY THE ECONOMIC SITUATION FACING THEM. THE POLITICAL CONSTRAINT REMAINS A MAJOR CONSIDERATION, AND PARTICULARLY THE GOVERNMENT'S ABILITY TO IMPOSE THE DEFLATIONARY MEASURES BEING DISCUSSED WITH IMF. NEVERTHELESS, GOP SEEMS DIFINITELY COMMITTED TO CONCLUDE SECOND TRANCHE AGREEMENT. ON THAT BASIS, WE RECOMMEND THAT WASHINGTON AGENCIES PROCESS U.S. LOAN AS RAPIDLY AS POSSIBLE SO THAT WE MIGHT BEGIN FORMAL NEGOTIATIONS.

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